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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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QUO VADIS? An old Wall Street adage says, "When everybody is bearish they are almost certain to be wrong; when everybody is bullish they are sometimes right for a while." This aphorism proved its merit amid the pessimism of late 1957 and 1958, and it could well prove its worth during the growing optimism of 1959. Wall Street is not immune to fashion's dictates, and it is now becoming quite fashionable to talk about 750-900 on the D-J industrials by 1960-61. Each passing day, in fact, finds another analyst, economist, or brokerage house climbing aboard the 750-900 bandwagon. But although this opinion is rapidly gaining acceptance, it is still a minority opinion. Obviously, if it were a majority opinion the market would already be in that lofty area, simply because everybody would be rushing in to buy. The bears are gradually losing face, and it is safe to say that when the bearish view becomes widely discredited and the bullish view is universally accepted, we will be at or near the final top. Stating it another way, a major movement (up or down) can only occur if that move is previously held improbable or impossible (and therefore not discounted by the market in advance).

The overriding question at this time is -- what does the investor or trader who follows the Dow Theory do from here on? If he has operated correctly over the long pull (and many readers have), he has ridden a great bull market from around 160-80 (D-J indust.) to the present record-breaking 670 level, If he has operated correctly over the shofter term as a trader, he has watched his line of stocks advance from about 430-50 in late 1957 to at least 600 in January of 1959 (and perhaps he still has many of his 1957-58 commitments intact at this time). "I bought them right, and I still have most of my stocks," says the reader. "Now, how far up should I ride them?"

As often stated in these Letters, we are now in the last half of the third phase of a great bull market. Because of this, a constant review of the technical condition of the market is of the utmost importance. Some of the technical indicators available are: the average yield on the D-J industrials, short interest, market breadth, upside and downside volume, odd-lot transactions, low-priced stock indexes, volume of transactions, and public psychology. Those who are bullish at this time point out that while many of the technical indicators are either neutral or even bearish, a few very important technical indicators imply that we are not yet at the top. The case for the bulls reads as follows: (1) The rail average has not yet bettered its 1956 high. By not confirming the industrial advance, rails have failed to fulfill the technical requirement for our final classification of the 1957-59 advance as a primary bull swing. I have voiced the opinion that this confirmation would eventually come. (2) The latest short interest figures show 3,264,000 shares on the short side, which brings the short interest-average volume ratio to 1.02. This figure is not yet indicative of a bull market top (.5 to .7 would be more like it). (3) Volume has not yet been of the championship proportions that might be expected in a bull market of this magnitude. So far, we have seen nothing like 6-8 million share days on the upside (which were typical of 1928-29). (4) Odd-lot purchases have been on the cautious side all through 1959; this implies a persistent skepticism on the part of the public regarding the possibility of higher prices. The odd-lotters are usually heavy buyers at the top, which is not the case at this writing.

Here, then, is the crux of the matter. It should be clear to every reader of these Letters that there is only one reason for holding a full portfolio of stocks from this point on, and that is a belief that this market will develop and top out in the accepted, classical manner, i.e. a full-scale third phase "blow-off". Those who are holding a large percentage of

common stock are speculating on a market "explosion" in which the public comes in "with both feet", stocks careen to unbelievable heights, speculation runs completely rampant, and volume climbs to perhaps 6-8 million shares per day in much the same atmosphere as that which existed during 1928-29.

I do not pretend to be the genius who calls the final top within a few days or weeks. Tops are extremely difficult to identify. Robert Rhea, who called the bottom of the 1932 bear market within a day or so, wrote of the 1929 top, "When the crash came in September-October, 1929, it was with considerable satisfaction that I realized how I had not been sucked into the whirlpool of frantic trading during the third phase of the bull market." Rhea had sold out during late 1928 and early 1929, along with many other Dow Theorists. In 1935 Rhea wrote, "I am prone to be right too soon in the third phase of a bull market." By any standards Rhea was a successful investor; yet he was not the greedy type of gambler who insists upon riding a bull market to its ultimate and dangerous conclusion.

I will repeat again that the safety factors in this bull market are diminishing. The industrial average is now 250 points and 21 months nearer its ultimate top than it was in October, 1957. As I see it, there are two choices open to each investor: (1) he can steel himself for a systematic campaign of unloading as the market surges higher. He will do this in the knowledge that he is willing to miss perhaps the last 10 to 20% of the move, and that safety of capital is every bit as important as capturing the last and most dangerous part of the advance; (2) he can hold his stocks through most of the third phase in the belief that this market will give fair warning of a top much as it did in 1929, 1937 and 1946. Here, of course, he is gambling on the hypothesis that the current bull market will top out in the same manner as previous bull markets. Although "crowd madness" is not guaranteed under the Dow Theory, I believe there is a strong possibility that this market will top out in the classical manner. In the final analysis, each investor must make his own choice. I, personally, have leaned towards the principles outlined in choice #1, and prefer not to ride to the final top in a fully invested position.

PRICE-MOVEMENTS. Readers should bear in mind that in discussing the price-movements we are at all times talking about three distinct market trends. The primary trend (the great, all encompassing tide of the market) is, of course, up and has been so since June, 1949. The secondary trend (the major movement within the primary trend) is up and has remained up since October, 1957. The minor or daily movement (which admittedly may be influenced by the news of the day) is also pointing up. The daily (Dow's third) movement is important mainly because it provides the first hint as to a change in the secondary trend.

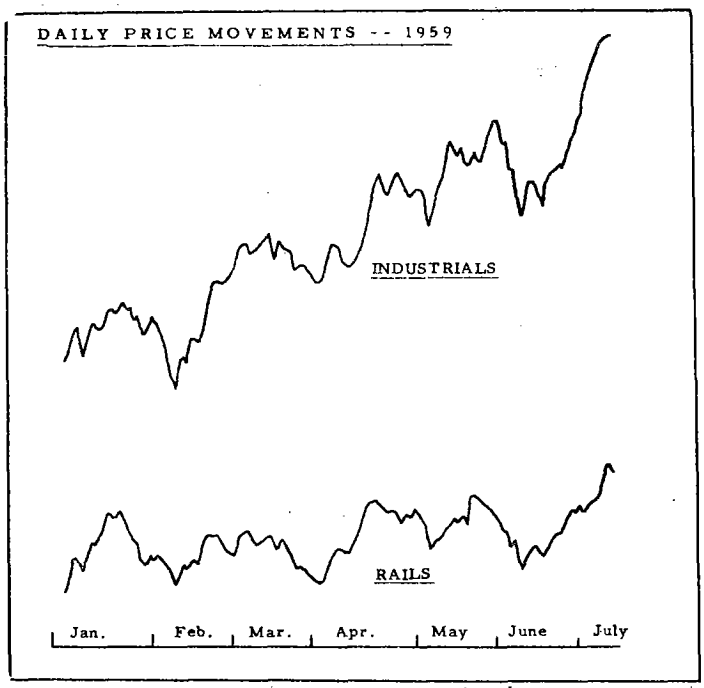
Since the last Letter industrials have spurted well above their previous high point (A - see chart), and volume has expanded bullishly with higher prices. Rails, on the other hand, have performed sluggishly (see Letter 73). Since the decline lows at B, however, rails have formed a tiny upward zig-zag pattern (B, Ba, Bb, Bc on chart). Such a pattern (although this is a minor one) is often the prelude to an advance, and it is interesting that this pattern has developed in the face of numerous warnings concerning the adverse effects of the steel strike on the carriers. Because the aforementioned pattern suggests underlying rail strength, there is a good chance that a rail confirmation (a bettering of the previous rail high at pt. A, 173.56) is in the making. Nevertheless, the rails should be watched carefully, and a consistant movement of this average against the industrials (divergence) could be the first sign of impending danger.

The entire rail picture is well worth studying. Readers who have been keeping their charts of the averages will note that over the last six months, the rail average has developed a series of four ascending bases. Such formations imply accumulation. In other words, each decline bottom was established at a higher level than the preceding bottom. We may infer that in time the floating supply of rail stocks will be absorbed, and the rail average will break out of its recent narrow range and try for the big move through the 181.23 high of 1956. The carriers have not attracted a following among the public, and it would be par for the course if the public "discovered" the rails after they completed a major advance through the 1956 high.

The secondary trend may be taken as continuing up as long as one or both averages hold above the decline lows at B (indust. 654.54, rails, 165.75). Prior to a rail confirmation (a rail bettering of the A high), if both averages turn down and violate their B points and volume increases significantly on the penetration, I would then say that the secondary trend was in the process of turning down. In that event, extreme caution would be warranted, and traders could protect themselves by taking profits.

SECURITIES. A number of readers have asked me, in view of the fact that they have taken some profits on the recent 21 month stock market rise, what they should do with the money. Following are my ideas. SHORT TERM OBLIGATIONS OF THE U.S. GOVERNMENT (bills, notes). This is the best place in the world to put cash. When you hold cash you want safety, and this is THE safest place. The new 4 3/4% notes have a beautiful yield and are already selling at a premium. In general, buy short-term treasury debt (a year or less). SAVINGS & LOAN ASSOCIATIONS -- Many of the S & L associations are now low on reserves, and here (despite the insurance) you are a partner, not a debtor. Prefer the treasury notes by far. SAVINGS BANKS You are at least a debtor here, but who needs them with the Government paying you a far better return. INDUSTRIAL BONDS With the yield cycle headed up, I wouldn't touch them. UTILITY BONDS same as industrials. R.R. BONDS At least a speculation because of fat yields, but we're talking about safety. MUNICIPAL BONDS I think they're headed lower with the general bond market. REAL ESTATE Worst of all. Non-liquid and will collapse in value with a bear market. Real estate should have been bought over the last ten years, and should be a good sale in the period ahead.

The following stock groups are showing up relatively stronger than the market. Banks, finance companies, soft drinks and farm equipment. Railroad equipment and liquor just turning up. Some aircraft (Lockheed, Boeing) appear to have bottomed out, as do many of the oils. (Written August 3 - after the close)



Note on the above chart the three ascending rail bases established in February, April, and June. The fourth base appears to have been made in July on our daily chart.